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TAGS: ECON EFIN PREL TU
SUBJECT: BANKING SECTOR PREPARES FOR A "BRAVE NEW WORLD"

¶1. (SBU) Summary: The strong profits reported by Turkish banks in 2003's third quarter show that the sector is gradually recovering from the effects of the 2001 crisis, according to industry analysts in Istanbul. They note, however, that much of the recent good news is the result of the windfall profits that banks have enjoyed as a result of declining interest rates, which have raised the value of their Treasury securities. Banks, they warn, have yet to show that they will be able to prosper in the new environment that will result if Turkey is able to stay the course and achieve its goal of sustainable low inflation and interest rates. Analysts forsee a further wave of consolidation in the sector, arguing that banking restructuring is only "half complete." End Summary.

¶2. (SBU) A positive quarter: Most major Turkish banks easily beat analysts' expectations in their recently announced third-quarter results. Industry leader Akbank led the way with third quarter earnings of USD 376 million, bringing its nine month profit to USD 722 million, well above the market consensus of USD 572 million. Two of Turkey's other big four banks, Garanti and Yapi Kredi, also exceeded expectations, though more modestly, while Isbank slightly undershot analysts' expectations, largely due to higher loss provisions than analysts had expected.

¶3. (SBU) Treasury windfall: Closer examination of bank balance sheets, however, shows that the bulk of the profits stemmed from windfall profits on the banks' holdings of Treasury bonds, which comprise from one-third to one-half of major banks' assets. Akbank, for example, holds nearly USD 9.5 billion in government securities, composed of nearly 5.5 billion in trading securities, 3.5 billion in securities available for sale, and only USD 450 million in securities held to maturity. The latter figure is down significantly from its 2001 level of nearly USD 4.5 billion, reflecting the shift banks have made from holding securities to actively trading them in the secondary market. The trend is evident at other banks as well, though less dramatically, given that Akbank leads the industry with 50 percent of its assets in government paper. Garanti, for instance, has Treasury holdings of USD 5.8 billion (out of total assets of 14.2 billion), but most of these are earmarked to be held to maturity, and a smaller percentage (28 percent) are denominated in Turkish lira. The continuing bias of Turkish banks towards government paper was evident in recently published comments by the General Manager of Vakifbank. Asked to predict the bank's year-end profits, he said they would depend on future Central bank rate cuts, given that bank profitability stems from its government securities portfolio.

¶4. (SBU) Loan expansion: Industry experts like Huseyin Imece at Yapi Kredi and Kubilay Cinemre at Garanti Bank stress that the banks' strong performance in the first part of the year is deceiving, in that the industry as a whole is not yet at a point where it achieves a sustainable operation from its core operations. Of Turkey's big four, only Yapi Kredi currently has a loan portfolio that eclipses its security portfolio. Other banks are seeking to expand market share, however. Akbank's market share in retail loans and SME's almost doubled in the first nine months of 2003, but the bank's total loan portfolio is still only half the size of its security portfolio, at USD 4.85 billion. Garanti's market share in retail loans increased from 18 to 25 percent, while the bank's overall loan portfolio expanded by 6 percent to USD 4.4 billion, or 31 percent of assets. Cinemre stressed, however, that banks cannot be profitable simply on the basis of these products alone: new instruments are needed, such as a long-term mortgage system.

¶5. (SBU) Restructuring: Ercan Kumcu, who in addition to

writing regularly on economic topics in "Hurriyet" newspaper, also heads Tekfenbank, one of the industry's smallest players, told us recently that while important progress has been registered in recent years in restructuring the sector, the process is still only half complete. Beyond the issue of weak banks in the system that may have to be taken over, there are also structural problems, stemming both from high intermediation costs as a result of excessive government taxes, and banks' own propensity to "overbranch." (Note: The IMF and World Bank are working with the GOT to find ways to bring down intermediation costs, and the GOT has agreed to a modest reduction in taxation on bank transactions beginning in 2004. But the GOT is constrained by the need for revenue to meet its fiscal targets. End Note.) According to Kumcu, further consolidation in the sector is essential, as is additional foreign investment. With foreign banks currently only holding a small fraction of the market, there is significant room for them to expand.

¶6. (SBU) Other clouds: Kubilay warned of additional clouds on the horizon, however, as a result of the new draft banking law currently being debated in parliament. As a reaction to the wave of bank failures in the 2001 crisis and the recent IMAR bank scandal (newspaper headlines recently trumpeted Justice Minister Celik's outrage at finding himself sharing a VIP waiting lounge with the former head of a failed Turkish bank, which had required the injection of hundreds of millions of dollars of government funds), the draft provides stiff penalties for bankers in the event of bankruptcy as a result of high losses. The law, Kubilay noted, would permit seizure of the personal assets of bankers and their families in such instances. Inevitably, he argued, such regulations would have a chilling effect on the sector and dissuade bankers from assuming any risk. The Banker's Association has reportedly been urging the GOT not to make this feature of the law quite so draconian. IMF staff reportedly agree that it is too draconian, but attach greater priority to the portions of the draft legislation relating to the bank regulatory and deposit insurance agencies.
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